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BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Integrate Procurement Policies and Consider Long-Term Procurement Plans.	R.06-02-013 (Filed February 16, 2003)

NOTICE OF EX PARTE COMMUNICATION

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Date: November 7, 2007

BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

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NOTICE OF EX PARTE COMMUNICATION

Pursuant to Rule 8.3 of the Commission's Rules of Practice and Procedure, the Independent Energy Producers Association ("IEP") provides the following notice of ex parte communication.

On Friday, November 2, 2007 at 11:00 a.m., a meeting was held between representatives of IEP and representatives of President Peevey. In attendance for IEP were Steven Kelly, Policy Director of IEP; Margaret Meal, outside consultant for IEP; and Brian Cragg, outside counsel for IEP. In attendance from President Peevey's Office were Nancy Ryan, Chief of Staff to President Peevey, and Andrew Schwartz, advisor to President Peevey. The meeting took place at the Commission's offices and was initiated by Mr. Cragg. The meeting lasted about 55 minutes.

During the meeting, Mr. Kelly outlined the current treatment of debt equivalence in the evaluation of bids in competitive solicitations for electric generating resources. Ms. Meal described debt equivalence associated with utilities' purchases under power purchase agreements ("PPAs") and how its impact was evaluated by the credit rating agencies. She explained that debt equivalence was not a direct cost and that it has no impact on the balance sheets of the purchasing utilities. She explained the importance to rating agencies of regulatory mechanisms and legislative assurances for recovery of the costs incurred under a PPA. She then described what happens with regard to debt equivalence when a California utility enters into a PPA. Mr. Cragg stated that consideration of debt equivalence in the evaluation of bids in competitive solicitations tilted the evaluation in favor of utility-owned projects and projects with lower capacity costs and shorter contract terms, even though the Commission's policy on renewable power and greenhouse gas reduction might encourage projects with relatively high capacity costs. For that reason, among others, debt equivalence should not be included in the evaluation of PPA bids. Ms. Meal stated that focusing only on one possible risk in bid evaluation while ignoring the risks that PPAs enable the utility to avoid skewed the evaluation. Finally, Ms. Meal explained how any debt equivalence impacts on credit quality are accounted for in cost of capital proceedings where all of a utility's risks can be evaluated and where utilities can be compensated for any adverse impacts of debt equivalence.

Four documents were used during the course of this meeting:

1. A one-page document entitled "IEP Meeting on Debt Equivalence."
2. A table listing risks associated with power plants and showing how those risks are allocated.
3. A chart showing the California utilities' bond ratings.
4. An excerpt from IEP's Opening Brief.

Copies of these documents are attached to this notice.

To obtain a copy of this notice, please contact Melinda LaJaunie at Goodin, MacBride, Squeri, Day & Lamprey, LLP, 505 Sansome Street, 9th Floor, San Francisco, California 94111, (415) 392-7900.

Respectfully submitted this 7th day of November, 2007 at San Francisco, California.

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BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

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OPENING BRIEF OF THE INDEPENDENT ENERGY PRODUCERS ASSOCIATION

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the seller's bankruptcy.

3. **Debt Equivalence**

a. **Background**

Debt equivalence ("DE"), also referred to as imputed debt, is a term rating agencies use to describe the potential financial risks a utility may incur when it enters into a long-term PPA. Under certain specific circumstances, a rating agency may treat some portion of the utility's obligation under the PPA as equivalent to debt, rather than operating costs, and may adjust the utility's credit metrics and financial ratios to reflect increased levels of debt.

At some point, debt equivalence *may* reach a point where it can affect the utilities' credit ratings and cost of capital, and it is not disputed in this proceeding that the potential effect of debt equivalence on credit ratings, if any, is an appropriate topic for the utilities' cost of capital proceedings. In this proceeding, however, the issue is "the use of debt equivalence in contract/bid evaluations . . . ."[19]

When the Commission considered this issue in the last procurement proceeding, it authorized the utilities to "take into account the impact of DE when evaluating individual bids . . ." and directed the utilities to use a 20% "risk factor" for all PPAs, based on a discount of the 30% risk factor developed by Standard and Poor's (S&P) for the California utilities.[20] The Commission also acknowledged, however, "As the rating agencies' views on DE change or as we gain more experience with DE evaluation in the [cost of capital] proceedings, we may adjust the DE methodology used in [the] future."[21] The Commission also stated its desire "not . . . to

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[19] Administrative Law Judge's Ruling, May 2, 2007, p. 7, fn. 9.

[20] D.04-12-048, pp. 144-145. In practice, the three utilities use the adopted 20% risk factor in a calculation to determine a "bid adder" for debt equivalence that is added to the cost of a PPA for purposes of bid evaluation. See Exh. 96, p. 12 (Meal/IEP).

[21] D.04-12-048, p. 145.

create an unfair burden on or a disadvantage for independent power sources over utility-owned, especially in the case of renewable resources."[22]

Since the issuance of D.04-12-048, both the Commission and the rating agencies have gained more experience with debt equivalence, and despite the Commission's good intentions, the 20% debt equivalence risk factor the Commission authorized in D.04-12-048 (and the resulting bid adder that is applied to PPA bids) has created an unfair disadvantage for independent power sources. The time has come for the Commission to eliminate debt equivalence in the evaluation of bids in competitive solicitations.

(1) **Definition of Debt Equivalence**

Margaret Meal, IEP's expert witness on debt equivalence, provides a succinct description of debt equivalence and its implications:

> In this context, "debt equivalence" (DE, also called "imputed debt") is a tool used by credit rating agencies to assess *potential* financial risks associated with a utility's PPA obligations. *In certain circumstances,* a rating agency *may* treat some portion of PPA costs as payments on debt obligations rather than as operating costs (treating them as "debt equivalent"), and in turn make corresponding adjustments to the utility's credit metrics and financial ratios used as part of the rating agency's overall assessment of credit quality.[23]

(2) **The Commission's Current Policy on Debt Equivalence**

The Commission currently considers debt equivalence in two different contexts. First, debt equivalence is one of several considerations that rating agencies factor into their assessment of a utility's overall risk profile. The Commission considers the rating agencies' credit ratings in the cost of capital proceeding and thus at least implicitly considers debt

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[22] D.04-12-048, p. 145.

[23] Exh. 96, pp. 8-9 (Meal/IEP) (emphasis added).

equivalence when it sets the utilities' cost of capital. In the current cost of capital applications (A.07-05-003 (SCE), A.07-05-007 (SDG&E), A.07-05-008 (PG&E)), for example, the utilities cite various factors in addition to debt equivalence as affecting their risk: loss of load due to direct access, community choice aggregation, and municipalization, high levels of capital spending and construction, high retail rates, fuel price volatility.

The second context is the one relevant here, the use of debt equivalence in evaluating offers in competitive solicitations. In D.04-12-048, the Commission concurred with the utilities' proposal to base the debt equivalence adder on S&P's approach, "because it is the most developed and transparent approach to calculating DE."[24] The Commission modified the S&P approach, however, because the 30% risk factor that S&P then applied was "too high to be reasonable and fair to all PPAs," and the Commission did not want "to create an unfair burden on or a disadvantage for independent power sources over utility-owned . . . ."[25] For those reasons, the Commission elected to discount S&P's risk factor by one-third from 30% to 20% for purposes of evaluating bids in competitive solicitations.

Regardless of the Commission's intentions, the debt equivalence bid adder puts PPAs at an immediate disadvantage in relation to projects that the utility will own, which are not subject to any sort of incremental risk adder in the bid evaluation to account for the incremental risk taken on by the utility when it pursues new utility-owned projects. This debt equivalence adder is added to the cost attributed to an individual PPA and is considered in isolation from the utility's overall risk profile.

The Commission also indicated in D.04-12-048 that this approach was not fixed

[24] D.04-12-048, p. 144.
[25] D.04-12-048, pp. 144-145.

and immutable:

> DE is a subjective factor based on the credit rating agencies' perceived risk associated with PPAs. The credit rating agencies' views on such risk are not static and can change with respect to a particular PPA during the term of the PPA. In addition the imputed DE costs for existing PPAs will be reduced as the regulatory climate in California improves.[26]

The Commission went on to conclude, "As the rating agencies' views on DE change or as we gain more experience with DE evaluation in the [cost of capital] proceedings, we may adjust the DE methodology used in [the] future."[27] The current proceeding provides a timely opportunity to reconsider and eliminate the use of debt equivalence in the evaluation of bids.

(3) **Debt Equivalence at the Three Major Rating Agencies**

The three major rating agencies (Moody's, Fitch, and Standard and Poor's) approach debt equivalence differently when they evaluate the overall credit risk of a utility, but they share certain elements:

> All three consider both qualitative and quantitative factors. All three recognize that the extent of PPA risk is utility and contract specific. All three recognize that PPAs can have benefits that reduce risk for bond holders, shareholders and ratepayers. All three rating agencies' criteria allow for making quantitative adjustments to financial statements to account for <u>financial</u> risk of PPAs <u>*if it is found to exist*</u>. All three agree that depending on the terms of the contracts and regulatory treatment regarding recovery of PPA costs through rates, it <u>*may*</u> be appropriate to calculate debt equivalence and adjust financial statements and resulting credit metrics for that debt equivalence. Notably, for all three rating agencies, debt equivalence is assigned only in certain circumstances.[28]

From these common elements, the rating agencies diverge in their approach to

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[26] D.04-12-048, p. 144.

[27] D.04-12-048, p. 145.

[28] Exh. 96, pp. 23-24 (Meal/IEP) (emphasis in original).

debt equivalence.

(a) Moody's and Fitch Assign Little or No Debt Equivalence to PPAs of Utilities Under the Commission's Jurisdiction

Moody's assigns no debt equivalence risk in jurisdictions where regulators allow the recovery of contract costs in rates:

> Some utilities have the ability to pass through the cost of purchasing power under PPAs to their customers. As a result, the utility takes no risk that the cost of power is greater than the retail price it will receive. *Accordingly Moody's regards these PPA obligations as operating costs with **no** long-term debt-like attributes.*[29]

Fitch takes a similar stance for slightly different reasons:

> Fitch views power purchase commitments as a component of the operating expense of a utility or merchant energy company, not a debt instrument. As a general policy, Fitch does not adjust the debt of utilities and others in the sector to reflect power purchase obligations as quasi-debt, nor does it impute a portion of long-term purchased power expense as interest expense. In certain relatively rare cases, however, uneconomic contracts may be treated as debt-like obligations.[30]

Moody's and Fitch do not separately identify the level of PPA debt equivalence in their utility credit rating reports. However, considering the statements made in Fitch's and Moody's published methodologies, these agencies' reported financial ratios for the California utilities (which could not be achieved with any significant level of debt equivalence), and California's strong regulatory assurances regarding cost recovery, it is likely that little or no imputed debt is assigned by Moody's and Fitch to the PPAs of California utilities. Inexplicably,

[29] Moody's Investors Service, Rating Methodology: Global Regulated Electric Utilities, March 2005 (hereafter, "Moody's Global Electric Utilities") (emphasis added), quoted in Exh. 96, p. 25 (Meal/IEP).

[30] Fitch Ratings, "Are Power Contracts Debt Equivalents?" Global Power Quarterly, July 2006' quoted in Exh. 96, p. 27 (Meal/IEP).

the utilities' testimony reaches the opposite conclusion, arguing that since Moody's and Fitch do not report imputed debt levels, the imputed debt levels must be the same as S&P's. This conclusion, however, ignores Moody's and Fitch's published reports and is equivalent to relying solely on S&P's approach.

(b) **S&P's Approach**

S&P considers two measures of risk, business risk and financial risk. Business risk is evaluated qualitatively; the assessment of financial risk is based on various credit metrics. In evaluating PPAs, S&P views some long-term PPAs with fixed capacity payments as creating financial obligations for utilities that in certain circumstances can resemble debt. After considering the terms of the PPA, regulatory assurances of recovery of PPA costs, and other factors, S&P assigns a risk factor (of between 0% and 100%) to the net present value of capacity payments under the PPA to calculate a debt equivalence amount that is considered as part of the credit rating process.[31]

S&P also recognizes the positive effects of PPAs on a utility's business risk, distinct from any impact debt equivalence may have on a utility's financial risk:

- "Buying power may be a more appropriate option for a utility than new plant construction because the utility avoids construction costs and the financial risks posed by regulatory lag when seeking recovery of costs."
- "Purchasing power may enhance supply flexibility, fuel resource diversity, and maximize load factors."
- "Utilities that plan to meet demand projections with a portfolio of supply side options also may be better able to adapt to future growth uncertainties."[32]

Like Moody's and Fitch, S&P considers whether the regulatory jurisdiction allows timely

[31] Exh. 96, pp. 28-29 (Meal/IEP).

[32] Standard and Poor's, Assessing U.S. Vertically Integrated Utilities' Business Risk Drivers, September 14, 2006, quoted in Exh. 96, p. 29 (Meal/IEP).

recovery of fuel and purchased power costs.

Thus, the Commission's current approach to debt equivalence for bid evaluation purposes is based solely on S&P's quantitative methodology for assessing the impact of PPAs on financial risk. This exclusive reliance on one element of S&P's methodology while ignoring Moody's and Fitch's methodologies contrasts with the Commission's approach in cost of capital proceedings, where the Commission considers the credit ratings of all three rating agencies and a number of additional factors before arriving at its assessment of each utility's cost of capital. In the evaluation of competing bids in RFOs, the Commission's current approach to debt equivalence effectively ignores the judgment of two of the three major rating agencies, and the consequence is a distorted evaluation of the true cost of PPAs.

(c) All Three Rating Agencies Agree that Regulatory Assurances of Cost Recovery Mitigate or Eliminate Debt Equivalence Concerns

Despite their varying approaches to debt equivalence, the three rating agencies agree that the potential risk of debt equivalence is mitigated or eliminated in jurisdictions that provide assurance of prompt recovery of the costs a utility incurs under PPAs. As the quote above indicates, Moody's assigns "no long-term debt-like attributes" when the utility has the ability to pass through the costs of its PPAs and there is no risk that the cost of power will exceed retail rate recovery. Similarly, Fitch states that it will not treat a PPA as a debt-like obligation unless (among other conditions) the utility has a "low likelihood of recovering the contract cost from expected revenues from regulated utility customers . . . ."[33] For its part, S&P notes, "The risk factor is largely a function of the strength of the regulatory recovery mechanisms established

[33] Fitch Ratings, "Are Power Contracts Debt Equivalents?" Global Power Quarterly, July 2006, quoted in Exh. 96, p. 27 (Meal/IEP).

to address procurement costs."[34]

(d) **California Provides Assurance of Cost Recovery**

In California, two mechanisms assure that the utilities will recover the costs of PPAs. First, Assembly Bill ("AB") 57, enacted in 2002, includes this clear statement: "Any purchases made in compliance with the commission-authorized [competitive procurement] process shall be recovered in the generation component of rates."[35] An approved procurement plan is to include:

> Upfront achievable standards and criteria by which the acceptability and eligibility for rate recovery of a proposed procurement transaction will be known by the electrical corporation prior to the execution of the bilateral contract for the transaction. The commission shall provide for expedited review and either approve or reject the individual contracts submitted by the electrical corporation to ensure compliance with its procurement plan. To the extent the commission rejects a proposed contract pursuant to this criteria, the commission shall designate alternative procurement choices obtained in the procurement plan that will be recoverable for ratemaking purposes.[36]

As a final assurance of cost recovery, AB 57 provided that an approved procurement plan must:

> Ensure timely recovery of prospective procurement costs incurred pursuant to an approved procurement plan. The commission shall establish rates based on forecasts of procurement costs adopted by the commission, actual procurement costs incurred, or combination thereof, as determined by the commission. The commission shall establish power procurement balancing accounts to track the differences between recorded revenues and costs incurred pursuant to an approved procurement plan. The commission shall review the power procurement balancing accounts, not less than semiannually, and shall adjust rates or order refunds, as necessary,

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[34] Standard and Poor's, Assessing U.S. Vertically Integrated Utilities' Business Risk Drivers, September 14, 2006, quoted in Exh. 96, pp. 29-30 (Meal/IEP).

[35] Pub. Util. Code § 454.5(c)(1).

[36] Pub. Util. Code § 454.5(c)(3).

> to promptly amortize a balancing account, according to a schedule determined by the commission.[37]

The Commission's implementation of the last provision led to the second cost recovery mechanism that reduces the potential risk of PPAs. In compliance with the statute, the Commission has established a balancing account, the Energy Resource Recovery Account ("ERRA"), that assures that the utilities' collected revenues and resource costs remain in balance.[38] The rating agencies have taken favorable notice of AB 57; when it upgraded SCE's ratings, Fitch specifically cited AB 57 and the "[t]imely and full recovery of procurement costs by investor-owned utilities . . . " that it provides.[39]

b. The Debt-Equivalence Adder Should Be Eliminated Because it Unfairly Disadvantages Independent Power Producers

The use of debt equivalence in bid evaluation creates a bias against PPAs that frustrates the Commission's goal of promoting fair competition between PPAs and utility-owned projects. This bias and several other developments support the conclusion that the debt-equivalence adder must be eliminated.

(1) Applying the Debt-Equivalence Adder to PPAs Tilts the Choice Toward Utility-Owned Projects

By applying an excessive debt-equivalence adder to PPAs but not explicitly recognizing the incremental risks associated with utility-owned projects, the current approach has the effect of favoring utility-owned projects over PPAs in the head-to-head competition the Commission is attempting to promote. This tilting of the playing field has at least two harmful effects. First, it will harm ratepayers when utility-owned projects are selected over less-

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37 Pub. Util. Code § 454.5(d)(3).

38 See D.02-10-062, pp. 60-66, for a description of the ERRA.

39 Fitch Ratings, "Fitch Upgrades Southern California Edison's IDR to A-, Outlook Stable," September 27, 2006, quoted in Exh. 96, p. 28 (Meal/IEP).

expensive PPAs because the debt-equivalence adder inappropriately boosts the PPA's bid for bid-evaluation purposes above the bids of more expensive utility-owned projects. Fair competition should mean that the least-expensive project that meets the requirements of the solicitation should be selected and that the risks of certain competitors are not ignored while other competitors' bids are inappropriately increased to reflect the cost of certain risks that do not exist. Second, sponsors of projects that are seeking PPAs may decide not to participate in solicitations if utility-owned plants are expected to compete, because the project's likelihood of success is reduced due to the effect of the debt-equivalence adder.[40] A reduction in the number of participants in a solicitation lowers the competitive pressure that leads to the ratepayer benefits that the Commission foresaw when it endorsed all-source solicitations in D.04-12-048.

(2) The Current Debt-Equivalence Adder Overstates the Effects of PPAs on Utility Credit Ratings

The Commission's current approach to debt equivalence implicitly assumes that PPAs will create a direct cost for the utility, a cost which must be accounted for through a debt-equivalence adder applied to bids for proposed individual PPAs. There are several reasons this assumption is not valid.

First, as explained above, the Commission's exclusive reliance in D.04-12-048 on the S&P formula ignores the fact that Moody's and Fitch take significantly different approaches to debt equivalence. As discussed above, Moody's and Fitch likely assign little or no debt equivalence to the utilities' PPAs.[41] For jurisdictions (like California) where the costs of PPAs are passed through directly to customers, both Moody's and Fitch conclude that the costs of

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[40] SCE sidesteps this argument by stating that because PPAs and utility-owned generation are essentially incompatible, debt equivalence should be used only to rank PPAs, not to compare PPAs and utility-owned projects. (Exh. 38, pp. 21-22 (Boada/SCE).)

[41] Exh. 96, pp. 25-28 (Meal/IEP).

PPAs should be treated like operating costs for the utility, not as a debt equivalent. Only S&P concludes otherwise, and the Commission's ignoring of the other rating agencies' views overstates the actual effect of PPAs on the utilities' credit ratings.

Second, reliance on S&P's formula (or any other formula that is used to adjust financial ratios) for purposes of bid evaluation assumes that changes in financial ratios have a direct correlation to changes in credit ratings, and that changes in credit ratings in turn have a direct correlation to changes in cost of capital. All three rating agencies emphatically state that there in fact is no direct or quantifiable relationship between changes in credit metrics and credit ratings.[42] Credit ratings assigned by the rating agencies are based on both qualitative and quantitative assessments. Financial ratio targets for particular credit ratings are published as broad ranges, and changes in financial ratios do not always result in changed credit ratings.[43] For these reasons and others, the Commission considers more than just credit ratings when it sets the cost of capital.

Third, credit ratings are set after a rating agency considers a variety of risk factors, and a change in a utility's credit rating has never been attributable to a single PPA. Even if a utility's reliance on PPAs reached levels where debt equivalence *might* have a direct effect on credit ratings, it is unfair to penalize an individual proposed PPA in its competition with utility ownership options by artificially inflating its bid to compensate for alleged costs that are not within its control.

Fourth, as the rating agencies and the utilities have recognized, the Commission's implementation of AB 57 and the development of the ERRA has done much to provide the

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[42] Exh. 96, pp. 32-33 (Meal/IEP).

[43] In its rebuttal on this point, SCE admits that financial ratios are not the "sole determinant" of credit ratings. Exh. 38, p. 23 (Boada/SCE).

utilities with an assurance of prompt cost recovery for PPAs entered into as part of a long-term procurement plan. This assurance of prompt recovery is likely the primary reason that Moody's and Fitch assign little or no debt equivalence to the California utilities' PPAs. Even S&P acknowledges that this sort of prompt and assured cost recovery could reduce risk factors to as low as zero.[44] This consideration, perhaps more than any other, compels the Commission to reconsider the approach it adopted in D.04-12-048 and to eliminate its reliance on the S&P formula.

Fifth, since the utilities resumed procurement in January 2003, their credit ratings have improved in spite of (or in part because of, as discussed below) a relatively large PPA element in their supply portfolios.[45] No credit downgrades for California utilities have occurred as a result of debt equivalence.

Sixth, as described below, S&P has reduced its risk factor for the PPAs of California utilities by one-sixth (from 30% to 25%).[46] It would be inappropriate and expensive for ratepayers for the Commission to cling to an outdated approach to debt equivalence. Even if the Commission decides to continue the existing methodology, the 20% risk factor currently used in bid evaluation should be reduced at a minimum by one-sixth, to no more than 16.7%.

The Commission should also keep clearly in mind as it considers this issue that ratepayers are harmed to the extent that its debt-equivalence approach overstates the effect of PPAs on a utility's credit rating and cost of capital. An overstated debt-equivalence adder means that a higher bid from a utility-ownership resource can beat out a lower bid from a PPA. Ratepayers' interests are not served when they are forced to bear the higher *actual* costs of a

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[44] Exh. 96, p. 36 (Meal/IEP).
[45] Exh. 96, p. 16 (Meal/IEP).
[46] Exh. 96, p. 36 (Meal/IEP).

utility-owned resource because over-inflated costs were *imputed* to a less-expensive PPA.

(3) Conditions Have Changed Since the Issuance of D.04-12-048

As the Commission foresaw in D.04-12-048, the regulatory climate in California has improved since 2004, and other significant changes relating to debt equivalence have also taken place.

(a) S&P Lowered the Risk Factor for the California Utilities

In D.04-12-048, the Commission based its approach to using debt equivalence for bid evaluation on the 30% risk factor that S&P applied to California utilities in 2004. In late 2006, however, S&P requested comments on proposed revisions to its assessment of debt equivalence. S&P's re-look at this methodology was prompted by its recognition that:

> the industry has established a very strong track record of demonstrating the viability and effectiveness of the various recovery mechanisms that state regulators have established for costs associated with contracted generation capacity. Recovery mechanisms have largely performed as intended, and related write-offs have proven to be very low.[47]

S&P's re-look has now resulted in a lowering of the risk factor from 30% to 25% for PPAs in jurisdictions where capacity costs of PPAs are recovered through a power cost adjustment mechanism.[48] The ERRA functions as a power cost adjustment mechanism in

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[47] Standard and Poor's, "Request for Comments: Imputing Debt to Purchased Power Obligations, Nov. 1, 2006, quoted in Exh. 96, p. 34 (Meal/IEP).

[48] Standard and Poor's, "Methodology for Imputing Debt for U.S. Utilities' Power Purchase Agreements," May 7, 2007, p. 3. This report, which was issued after testimony was served, follows up on the November request for comments and is appended as Attachment 2 to this brief. The record on debt equivalence would be greatly improved with this more recent information, and IEP respectfully moves for the Commission to take official notice of this report, under Rule 13.9 and Evidence Code section 452(h). IEP asks the Commission to take notice of this document for its statements about how S&P now approaches debt equivalence, and not for the truth of those statements.

California, and the capacity costs of PPAs are among the costs recovered through that mechanism. Thus, S&P now assigns a risk factor of 25% to the PPAs of PG&E, SCE, and SDG&E.

Equally significant is S&P's recognition that risk factors could be as low as 0% in jurisdictions where there are "legislatively created cost recovery mechanisms."[49] As mentioned above, rating agencies have noted with approval the enactment of AB 57, and the Commission's track record of allowing prompt recovery of eligible purchased power costs could lead to even lower risk factors for the utilities under its jurisdiction. In its response to S&P's proposal, SCE noted that "if there are regulatory and legislative guarantees of cost recovery, and the utility includes contracting as part of a well-thought-out resource strategy with regulatory approval, the risks associated with PPAs are substantially reduced." SCE also offered its opinion that a risk factor of about 10% was appropriate for utilities in jurisdictions with fuel adjustment clauses.[50]

In addition, S&P now incorporates a depreciation expense adjustment in its assessment of debt equivalence.[51] Previously, S&P imputed interest on debt equivalence without a corresponding imputation of depreciation. This change would immediately improve the financial ratios of the California utilities.[52]

Thus, even if the Commission retains the basic approach it adopted in D.04-12-048, the Commission should recognize S&P's recent changes to its debt-equivalence methodology in the protocols for bid evaluation. As a matter of consistency, the debt-

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[49] Standard and Poor's, "Methodology for Imputing Debt for U.S. Utilities' Power Purchase Agreements," May 7, 2007, p. 3.

[50] Southern California Edison Response to S&P's Request for Comments on Imputing Debt to Purchased Power Obligations, quoted in Exh. 96, p. 37 (Meal/IEP).

[51] Standard and Poor's, "Methodology for Imputing Debt for U.S. Utilities' Power Purchase Agreements," May 7, 2007, p. 2.

[52] Exh. 96, p. 35 (Meal/IEP).

equivalence adder for bid evaluation purposes should be reduced proportionally to the reduction of the risk factors that S&P assigns to the utilities.[53] However, there are additional factors that lead to the conclusion that debt equivalence should not be considered as all as part of the bid evaluation process.

(b) **Credit Ratings for California Utilities Have Improved**

In recent years, the credit ratings of California utilities have improved steadily. S&P upgraded both PG&E and SCE in early 2005, and improved its business profile for PG&E from 6 to 5 in early 2006. Very recently, S&P upgraded PG&E from BBB to BBB+. Fitch upgraded SCE in September 2006 and placed PG&E in the Ratings Watch Positive category in August 2006, and further upgraded PG&E from BBB to BBB+ in April 2007. Moody's upgraded PG&E in March 2005 to BBB+, and in April 2007 Moody's placed PG&E under review for a possible further upgrade to A- (in S&P equivalent ratings). Moody's upgraded SCE in October 2006. (SDG&E has been able to maintain A and A+ ratings.)[54] These upgrades have occurred despite S&P's assignment of imputed debt to the utilities' existing PPAs.

(4) **The Current Debt Equivalence Adder Overstates the Incremental Risk of PPAs Compared to the Incremental Risk of Utility Ownership Options**

An additional flaw in the Commission's current approach to debt equivalence in the bid evaluation process is that it contains no recognition that new utility ownership options carry their own risks, and no comparable adder for these risks is applied to bids for utility-owned projects. Taking on ownership of new generation increases a utility's risk profile compared to

[53] In D.04-12-048, the Commission reduced S&P's risk factor by one-third (from 30% to 20%) for bid evaluation purposes.
[54] Exh. 96, p. 16 (Meal/IEP).

the status quo. Increased capital spending, such as would be required for new utility-owned plants, also raises concern at the rating agencies.

(a) Incremental Capital Spending and New Utility Ownership of Generation Increase Utility Risk

The rating agencies have all expressed concerns about the effects of new utility capital spending programs, and the aggressive capital spending programs of the California utilities have drawn their special attention. S&P recognizes that a utility's needs to meet growth in demand increases risk, either by the utility taking on the risks of owning generation, or through imputed debt that may result from meeting demand with PPAs. Moody's sees SCE's and SDG&E's large capital spending programs as a barrier to further credit-rating improvement. Moody's noted that in light of SCE's "very sizeable capital expenditure program, as well as the region's need to add generating resources, some of which will likely be built by SCE, limited prospects exist for the rating to be upgraded over the next several years."[55] Moody's also took note of SDG&E's "higher capital expenditures expected in the near term for finance infrastructure and new generation projects" and stated that the increase in capital spending could limit the potential for upgrading SDG&E's rating.[56] Fitch has similarly specifically noted that capital spending is a risk for SCE and PG&E, and Fitch identified SCE's large capital spending program as a Key Credit Concern.[57]

A failure to recognize the risks of utilities' constructions programs and capital spending requirements distorts the head-to-head competition that the Commission said in D.04-

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[55] Moody's Investors Service, Credit Opinions, Southern California Edison Company, October 16, 2006, p. 3, quoted in Exh. 96, p. 19 (Meal/IEP).

[56] Moody's Investors Service, Credit Opinions, San Diego Gas & Electric Company, January 9, 2006, p. 2, , quoted in Exh. 96, p. 20 (Meal/IEP).

[57] Fitch Ratings, Credit Analysis, Southern California Edison Co., Oct. 30, 2006, p. 1, cited in Exh. 96, p. 20 (Meal/IEP).

12-048 that it hoped to encourage. In effect, the current debt-equivalence methodology compares PPAs to the status quo in which no new resources are added to the utility's resource base, not to utility-owned options that are proposed to fill the same need as the PPAs. To arrive at the head-to-head competition the Commission thought it was establishing in D.04-12-048, the Commission has two choices. It can either impose a utility-ownership adder to the bids for utility-owned projects to reflect the business risks of taking on new generation projects and the added financial risk presented by capital spending programs, or it can eliminate the debt-equivalence adder it now imposes on PPAs. The Commission's current practice, however, only produces skewed results and a distorted version of competition.

(b) The Utilities' Capital Spending Needs Create Additional Risks for Ratepayers

All three utilities have planned capital spending programs that will push capital spending well beyond the average levels of recent history, even before investment in new utility-owned generation is considered.[58] The rating agencies have noted this trend, and have indicated that these large capital spending programs may limit the prospects for improved credit ratings.[59] The bulk of the planned capital spending is for improvements to the transmission and distribution systems,[60] and additional spending on utility-owned generation projects will only increase the rating agencies' concerns.

Financing the development, construction, operation of utility-owned generation (either directly for utility-built plants or indirectly for turnkey projects) requires the utility either (1) to draw on internally generated sources of cash that would otherwise be available to invest in

[58] Exh. 96, pp. 18-19 (Meal/IEP).
[59] Exh. 96, pp. 19-20 (Meal/IEP).
[60] Exh. 96, p. 19 (Meal/IEP).

other needed capital projects or to support the utility's credit rating by making bond payments or paying dividends to shareholders, or (2) to raise funds in capital markets, which will stress the utility's credit quality. In either case, the financial strain of an already ambitious capital spending program will be exacerbated by the utility's pursuit of new utility-owned generation. In addition, utility-owned generation options expose ratepayers to development risks, construction risks, operating risks, capital market risks, and commodity price risks, and subject utility shareholders and bondholders to the risk that the Commission will not allow recovery of imprudently incurred costs.[61] These incremental risks and the cost of those risks are not currently accounted for in the evaluation of bids of utility-owned projects.

By contrast, when the utility enters into a PPA, the counterparty bears the development, construction, operating, financing, and capital market risks and those risks are shifted away from the utility and its bondholders and shareholders. This shifting of risks was noted by S&P in its Request for Comment:

> [A] PPA also shifts various risks to the supplier, such as construction risk and most of the operating risk. As a result, the principal risk borne by a utility that relies on PPAs is the recovery of the financial obligation in rates. While it is the utility that must of course make these payments, however, to the extent that regulators and, in certain cases legislatures, have structured recovery to assign the burden to ratepayers, the utilities' risk diminishes.[62]

Attachment 1 summarizes how various risks are allocated for PPAs and for utility-owned generation. As this table demonstrates, utility-owned generation options expose utility ratepayers, shareholders, and bondholders to incremental risks that are not accounted for

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[61] Exh. 96, p. 43 (Meal/IEP).

[62] Standard and Poor's, "Request for Comments: Imputing Debt to Purchased Power Obligations, Nov. 1, 2006, quoted in Exh. 96, p. 43 (Meal/IEP).

in the bid evaluation for a competitive solicitation. By contrast, PPA options allocate most of these risks to the owner of the plant supporting the PPA. Currently, only the risk of PPA imputed debt is quantified and added to PPA bids, while no risk or cost adder is added to utility-owned options to account for the incremental risks they pose to ratepayers. This difference in the way risks are accounted for in bid evaluation creates an unfair advantage in favor of utility-owned options.

(c) The Utilities Recognize the Incremental Risk of Capital Spending and Utility Ownership in their 2008 Cost of Capital Applications

The utilities recently filed their cost of capital applications for 2008 (A.07-05-003 (SCE), A.07-05-007 (SDG&E), and A.07-05-008 (PG&E)). In these applications, the utilities recognize that their ambitious capital spending programs can have an effect on their credit ratings and cost of capital. SCE, for example, states:

> SCE's system is aging and must be expanded to meet the demands of large numbers of new customers. SCE projects that, with regulatory and other approvals, it will invest $17 billion in its electrical system during the next five years. To fund the equity portion of this investment program, SCE will reinvest substantially all of its retained earnings. In addition, SCE may find that it must attract external equity capital. In order to justify the reinvestment and to raise the equity capital that may be required to finance such a large investment, SCE must be able to provide a compensatory return to its investors, which can only happen if the Commission authorizes a compensatory rate of return for SCE.[63]

PG&E sounds a similar note in the testimony accompanying its cost of capital application:

> The major bond rating agencies have specifically cited PG&E's substantial capital program and the ongoing exposure associated with power procurement and volatile energy markets. While providing the infrastructure necessary to meet the energy needs of

[63] Testimony in support of A.07-05-003, p. 7.

> customers is certainly desirable, it imposes additional financial responsibilities on PG&E. To continue to meet these challenges successfully and economically, it is crucial that PG&E receive adequate support to maintain its credit standing.[64]

Similarly, SDG&E described its ambitious capital spending plan and its implications:

> SDG&E is in the midst of a major capital investment program which includes significant and necessary investments in utility infrastructure. Over the next five years, SDG&E plans to spend approximately $4 billion in capital investments, which includes approximately $2.5 billion in CPUC-jurisdictional investments. This capital investment program which averages about $900 million per year is more than double SDG&E's historic investment level of between $400 and $450 million and is necessary to improve and expand its infrastructure, and expand its services to better serve a growing customer base. This expansion of services includes reentering the electric generation power plant business, making transmission investments necessary to relieve congestion and provide needed transmission access into San Diego, investing in renewables and other supply and demand resources to ensure the future energy needs are met in the San Diego region, and investing in new technologies like the Advanced Metering Infrastructure (AMI).[65]
>
> * * *
>
> With many essential [transmission and generation] projects competing for limited financial and human capital, and the huge expected capital outlay in the near future, the financial markets will view SDG&E as facing increased risk.[66]

c. **The Utilities' Rebuttal Testimony Includes Numerous Flawed Assumptions**

The utilities attempted in their rebuttal testimonies to respond to the points made in IEP's testimony on debt equivalence. That effort was unsuccessful, and the rebuttal testimony

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[64] Prepared Testimony in support of A.07-05-008, p. 2-30.

[65] Testimony of Michael M. Schneider, submitted with A.07-05-007, p. MMS-2.

[66] Prepared Direct Testimony of Michael M. Schneider, submitted with A.07-05-007, p. MMS-6.

includes several flawed material assumptions.

(1) The Utilities Continue to Ignore the Published Methodologies of Moody's and Fitch

The utilities continue to focus on S&P's assessment of debt equivalence. To the extent that the utilities mention the other major rating agencies, Moody's and Fitch, they assume without justification that since the overall credit ratings of the three rating agencies are generally similar, the other agencies' approach to debt equivalence must therefore be identical to S&P's. PG&E, for example, argues:

> Given that two of the rating agencies, S&P and Fitch, assign the same credit rating to PG&E, and Moody's assigns a credit rating one notch higher, a reasonable assumption is that all three credit rating agencies impute about the same level of risk to PG&E's PPAs."[67]

There are several flaws with this assumption. As previously discussed:

- It is likely that Moody's and Fitch assign little or no debt equivalence to PPAs;
- This assumption ignores the qualitative factors that S&P considers in developing credit ratings;
- This assumption erroneously presumes a direct link between financial ratios and credit ratings.

In addition, viewed from a broader perspective, S&P's ratings for the California utilities are generally lower than those of Fitch and Moody's: until recently, both Moody's and Fitch rated PG&E higher than S&P; both Moody's and Fitch rate SCE higher than S&P; and Fitch rates SDG&E higher than S&P and Moody's.[68] The overall pattern is that S&P tends to give the lowest ratings to the California utilities, which would be consistent with a greater

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[67] Exh. 18, p. 10-19 (Patterson/PG&E).
[68] See Exh. 96, p. 16 (Meal/IEP).

perception of risk by S&P.[69] Thus, the evidence PG&E cites to support its speculation actually supports the opposite conclusion.[70]

Moreover, SCE's direct and rebuttal testimonies argue that a portfolio that relies extensively on purchased power will result in downgrades by the rating agencies, possibly to ratings below investment grade. SCE's arguments rely on the assumption that S&P's debt equivalence formula is an accurate measure of the impact of PPAs on SCE's credit profile. SCE's calculations of its credit ratios also ignore that SCE plans to make significant additions to its capital base and revenues associated with large projected capital spending on transmission and distribution over the forecast period. These calculations therefore are unreasonable projections of SCE's credit ratios and significantly understate SCE's projected financial performance.

SCE also incorrectly asserts that S&P's "evergreen" treatment of short-term contracts, which assumes that the contracts will remain in effect for 12 years, regardless of the actual current contract term, will apply to all of SCE's short-term contracts and will increase debt equivalence by 61%.[71] S&P's evergreen proposal was more moderate than SCE portrays it. The revised methodology S&P published on March 30, 2007 in fact assigns debt equivalence only "selectively" to "a limited pool of utilities" and clearly states that "a blanket application of evergreen treatment is not warranted."

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[69] See Exh. 38, p. 23 (Boada/SCE).

[70] PG&E's rebuttal repeats this contradiction in several ways. For example, at one point PG&E states that "it is not possible to ascertain from any of their publications how much risk each rating agency attributes to PPAs when evaluating credit quality." (Exh. 18, p. 10-20 (Patterson/PG&E). In the very next sentence, PG&E contradicts itself and asserts that it *is* possible to discern how the agencies assess PPA risk from their publications.

[71] Exh. 38, p. 22 (Boada/SCE).

d. **<u>Any Effects of PPAs on the Utility's Financial Ratings Should Be Evaluated and Addressed Only in the Cost of Capital Proceeding</u>**

The Commission already considers the effect of any debt equivalence on the utilities' credit ratings in the cost of capital proceedings. To the extent that PPAs are perceived as adding imputed debt and thus affecting the utilities' financial ratios and cost of capital, that effect is taken into account in setting the cost of capital, and will be taken into account in future cost of capital proceedings.

Compensating for any effect of debt equivalence in both the cost of capital proceeding and in bid evaluation can expose ratepayers to a potential for double payment—once in a (marginally) higher cost of capital and again in the form of higher payments to a utility-owned plant that prevails over PPAs in a competitive solicitation only because the bids of the PPAs are raised by the debt equivalence adder. This potential creates a "win-win" situation for utility shareholders at the expense of ratepayers: first utility revenues are increased by a higher cost of capital, and second, utility revenues are increased due to investment in utility-owned generation assets that are higher-priced than their PPA competitors.

It its noteworthy that two consumer groups with different constituencies—Aglet and CLECA—both advocate that the implications of debt equivalence should be considered only in the cost of capital case.[72] In this instance, eliminating the debt equivalence adder for PPA bids avoids the possibility of double recovery by the utility and pays an even more important dividend in the form of a more competitive and more economic generation supply.

e. **Conclusion on Debt Equivalence**

The preceding discussion demonstrates that the Commission's approach to debt

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[72] Exh. 64, p. 47 (Barkovich/CLECA); Exh. 52, p. 3 (Reid & Weil/Aglet).

equivalence creates a disparity between the treatment of PPAs and utility-owned projects in the procurement process, in direct contradiction to the Commission's stated goal of promoting head-to-head competition between PPAs and utility-owned options. The evaluation of bids by PPAs in competitive solicitations includes a debt-equivalence bid adder that overstates the risks actually presented by IPP projects, while the evaluation of utility-owned projects includes no equivalent bid adder, even though utility-owned projects present considerable incremental risks to ratepayers and utility shareholders. Apart from the fact that a debt-equivalence adder immediately puts PPAs at a disadvantage in comparison to utility-owned projects, the bid adder skews the results of competitive solicitations, which will result in higher costs of power for ratepayers. If the Commission wants to encourage fair, head-to-head competition between PPAs and utility-owned projects, as it stated in D.04-12-048, then the Commission must eliminate the bid adder for PPAs to put them on the same standing as utility-owned projects. Based on a full analysis of all three of the rating agencies' treatment of debt equivalence, recent changes to these treatments, and the improved credit ratings of the California utilities, no debt equivalence adder is warranted. IEP urges the Commission to level the treatment of PPAs and utility-owned projects by eliminating the debt-equivalence bid adder adopted in D.04-12-048 for PPA bids.

RECOMMENDATION: The use of a debt equivalence adder in the evaluation of PPAs in competitive solicitations should be eliminated.

4. **<u>Transmission</u>**

5. **Other Contract and Bid Evaluation Issues**

E. **<u>TeVaR And Customer Risk Tolerance</u>**

F. **<u>Streamlining and Transparency of Compliance Filings</u>**

G. **<u>Other Procurement Process Issues</u>**

IEP Meeting on PPA Debt Equivalence

- **PPA debt equivalence (DE) – What is it?**
  - DE is a measure of financial risk of PPAs used by some rating agencies for some utilities.
  - DE is not a direct cost, and has no impact on an IOU's reported balance sheet.
  - In some cases, some rating agencies may treat a portion of PPA capacity payments as a debt obligation, weakening certain credit ratios used as a <u>part</u> of the bond rating process.
  - The amount of DE assigned is driven by regulatory assurances regarding cost recovery of PPA payments, which can significantly reduce or eliminate DE.

- **DE Example: What happens when a California IOU enters into PPA?**
  - California regulation assures cost recovery of PPA payments.
  - Moody's and Fitch assign little or no DE so credit ratios are not affected.
  - When PPA payments start, S&P includes 25% of capacity payments as debt for purposes of calculating the IOU's credit ratios.
  - Other generation-related risks are reduced or eliminated when an IOU enters into a PPA for generation: e.g., development, construction, operating and capital market risks.
  - As a result, any weakening of credit ratios is offset by other factors, the <u>overall</u> impact of the PPA on IOU credit quality and bond ratings is minimal, and there are no incremental costs to the utility.
  - <u>S&P's formula overstates PPA risk exposure for the California IOUs.</u>

- **DE should not be included in evaluation of PPA bids**
  - DE does not increase the cost of PPA bids: DE measures only one element of generation-related risk, and is only assigned by one rating agency.
  - Utility-owned power plants carry development, construction, operating and capital market risks that ratepayers bear and that are not assessed cost penalties in bid evaluation.

- **DE impacts on credit quality, if any, are accounted for in cost of capital proceedings – the IOUs are compensated for any adverse impacts of DE**

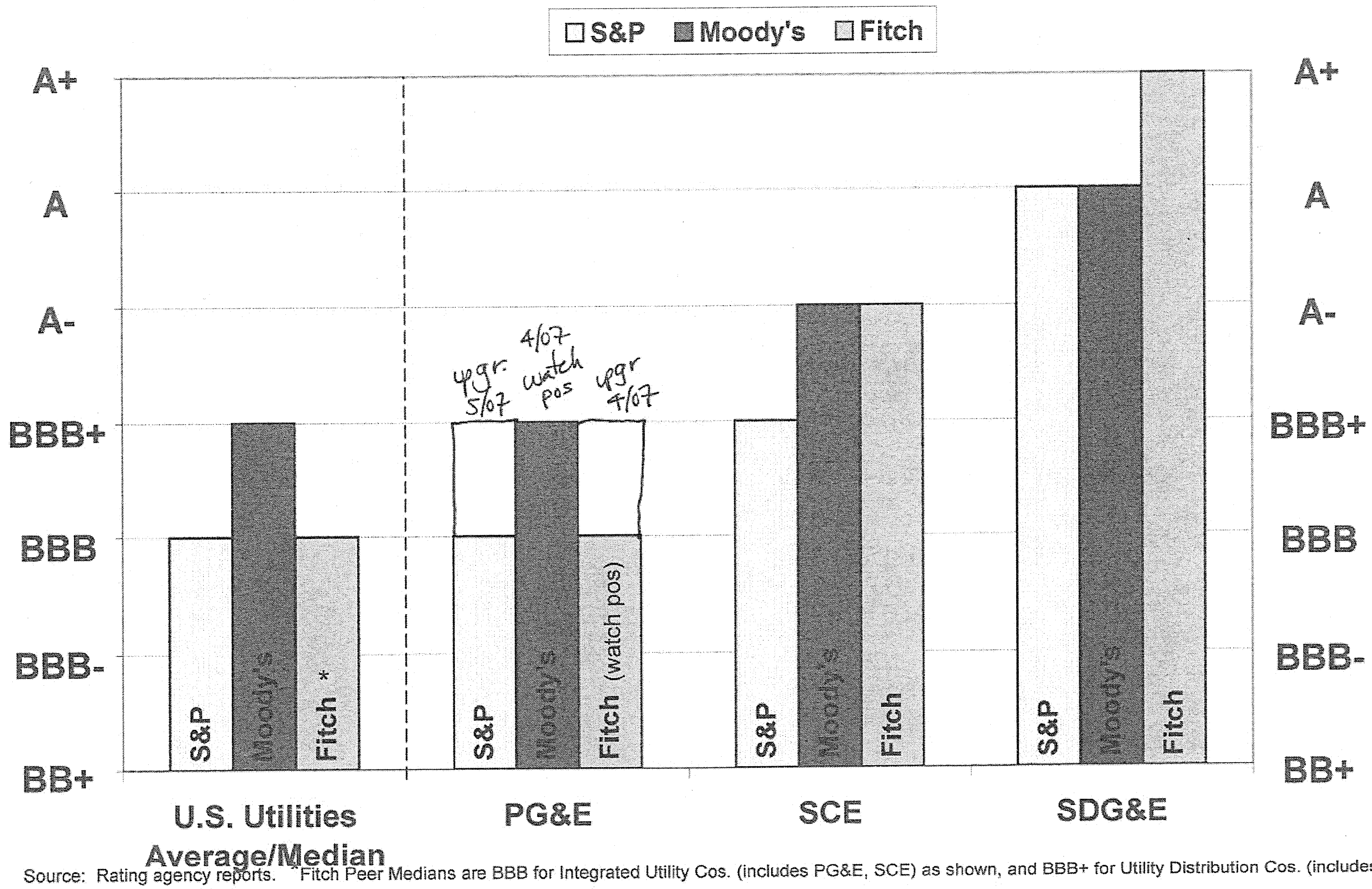
ATTACHMENT 1

Typical Power Plant Risks and Allocation		
Activities Creating Risks	**Party Allocated the Risk**	
	Independent Project	**Utility Cost of Service Project**
Site acquisition	Developer/Owner	Ratepayers
Permitting	Developer/Owner	Ratepayers
Unsuccessful projects	Developer/Owner	Ratepayers
Engineering	Developer/Owner	Ratepayers
Construction	Developer/Owner	Ratepayers
Schedule delays	Developer/Owner	Ratepayers
Start-up difficulties	Developer/Owner	Ratepayers
Plant performance	Developer/Owner	Ratepayers
Replacement power	Developer/Owner	Ratepayers
Financing	Developer/Owner	Ratepayers
Credit Assurance (if applicable)	Developer/Owner	Ratepayers
Debt equivalence (if applicable)	Ratepayers	N/A
Fixed Operations and Maintenance	Developer/Owner	Ratepayers
Variable O&M	Developer/Owner	Ratepayers
Extraordinary O&M	Developer/Owner	Ratepayers
Inflation	Developer/Owner	Ratepayers
Premature retirement	Developer/Owner	Ratepayers/ Shareholders
Technological obsolescence	Developer/Owner	Ratepayers

Current Issuer Ratings (February 2007): PG&E, SCE, SDG&E

(S&P Equivalent Ratings)

Current Ratings are at or above Rating Agency Peer Medians/Averages
all ratings have "Stable" outlook except Fitch has PG&E on Rating Watch Positive



Source: Rating agency reports. *Fitch Peer Medians are BBB for Integrated Utility Cos. (includes PG&E, SCE) as shown, and BBB+ for Utility Distribution Cos. (includes SDG&E).

CERTIFICATE OF SERVICE

I, Melinda LaJaunie, certify that I have on this 7th day of November 2007 caused a copy of the foregoing

NOTICE OF EX PARTE COMMUNICATION

to be served on all known parties to R.06-02-013 via email to those listed with email on the most recent service list on the CPUC website, and via U.S. mail to those without email service. I also caused courtesy copies to be hand-delivered as follows:

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ALJ Kenneth L. Koss
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I declare on penalty of perjury under California law that the foregoing is true.

Executed this 7th day of November 2007 at San Francisco, California.

/s/ Melinda LaJaunie
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2970/005/X94112.v1

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